

MINUTES OF THE REGULAR MEETING OF THE ARIZONA STATE RETIREMENT SYSTEM BOARD

**HELD ON
February 21, 2003
8:30 a.m., MST**

The Arizona State Retirement System (ASRS) Board met in the 10th Floor Board Room, 3300 N. Central Avenue, Phoenix, Arizona. Mr. Alan Maguire, Chairman, Arizona State Retirement System Board, called the meeting to order at 8:34 a.m., MST.

The meeting was teleconferenced to the ASRS office at 7660 East Broadway Boulevard, Suite 108, Tucson, Arizona 85710.

1. Call to Order; Roll Call, Opening Remarks

Present: Mr. Alan Maguire, Chairman
Ms. Bonnie Gonzalez, Vice Chairman (via telephone)
Ms. Charlotte Borchert (arrived at 9:08 a.m.)
Mr. Jim Bruner
Dr. Chuck Essigs (arrived at 8:38 a.m.)
Mr. Norman Miller (via telephone)
Mr. Karl Polen
Mr. Ray Rottas
Mr. N. Carl Tenney

A quorum was present for the purpose of conducting business.

Opening Remarks: Mr. Alan Maguire, Chairman, asked the not yet confirmed three new Board Member appointees to introduce themselves.

Steven Zeman, Phoenix
Replacing Bonnie Gonzalez – State

Mr. Zeman represents the active employees. He is a Revenue Field Auditor with the Arizona Department of Transportation. He has been with the state for almost 15 years. Prior to this, he has had experience in the private sector with Talley Industries, Motorola, and three Savings and Loan Institutions. He is originally from California.

Dr. Keith Meredith, Tucson
Replacing Alan Maguire – At-Large

Dr. Meredith is a retiree from the University of Arizona. He has been involved with the Arizona Center on Aging, the University of Arizona Retirees Association, and was Director of the Gerontological Studies Program at the University of Arizona for the last five years of his career.

Lawrence Trachtenberg, Scottsdale
Replacing Ray Rottas - Public

Mr. Trachtenberg currently serves as Executive Vice President, Chief Financial Officer, and General Counsel of Mobile Mini, Inc. in Tempe, Arizona. He's lived in Arizona for about nine years. While working with Mobile Mini, he's been involved with many investment professionals and bankers.

2. Approval of Minutes of the January 17, 2003, Regular Meeting of the ASRS Board

Motion: Mr. N. Carl Tenney moved to approve the minutes of the January 17, 2003, regular meeting of the ASRS Board.

Ms. Bonnie Gonzalez, Vice Chairman, seconded the motion.

By a vote of 7 in favor, 0 opposed, and 0 abstentions, 2 excused, the motion was approved.

3. Approval of the Consent Agenda

Motion: Ms. Gonzalez moved to approve refunds, death benefits, retirements, and system transfers, of the Arizona State Retirement System, and application and agreements with the Clearview Central Arizona Charter School.

Mr. Jim Bruner seconded the motion.

By a vote of 7 in favor, 0 opposed, and 0 abstentions, 2 excused, the motion was approved.

4. Presentation, Discussion and Appropriate Action Regarding the Legislative Update

Mr. Maguire asked the Board's permission, with Ms. Gonzalez' consent, to turn the meeting over to past Chairman Mr. Jim Bruner. He then excused himself at 8:36 a.m. to appeal to the Appropriations Sub-Committee on behalf of the ASRS budget for the coming year. Mr. Richard Stephenson, Deputy Director, External Affairs, was to co-present on this agenda item with Mr. Ray Rottas. However, he is at the Legislature at this time. Therefore, Mr. Rottas preferred to postpone the agenda item until Mr. Stephenson returned.

Dr. Chuck Essigs arrived at 8:38 a.m.

5. Presentation, Discussion and Appropriate Action Regarding Conducting an Actuarial Audit

Mr. Karl Polen, stated briefly the background of this issue. Two months ago, a presentation occurred at the Investment Review Committee concerning best practices for fiduciary standards of Trustees, particularly with respect to investment matters. In the course of that presentation, our consultant on this matter, recommended that it has become best practice to conduct a periodic actuarial audit, similar to a financial audit. This audit is conducted by an outside firm who confirms the work of the actuary.

The Actuarial Study is a document of tremendous importance and drives much of what the ASRS does. This document involves our projections of cash flows to meet benefits based on many assumptions. Assumptions such as; how many employees we have, when they will retire, how long will they live, future pay raises and much more. An actuarial audit has never been conducted by this agency before. In light of our Actuary bringing to the Board's attention that the best retirement plans are including this as a best practice, Mr. Polen felt this was worthwhile to bring to the attention of the Board. It is his recommendation to conduct this audit. Based on informal research from Mr. Matson, the fee for this audit is roughly \$50,000. While this sum is not taken lightly, the ASRS is managing \$17,000,000,000 and is dealing with the lives of over 300,000 members, as a result, this audit seems appropriate.

Dr Chuck Essigs, commented that this audit would be an excellent idea at any time, but especially now with the changes in contribution rates and concerns regarding the stability of retirement systems across the country.

Motion: Ms. Gonzalez moved to move forward with the Actuarial Audit.

Mr. Ray Rottas seconded the motion.

By a vote of 7 in favor, 0 opposed, and 0 abstentions, 2 excused, the motion was approved.

Mr. Bruner asked Mr. Matson about the timing of the next step in this process.

Mr. Matson stated that research is being conducted on the Scope of Work. This research will be completed over the next two weeks. With the Board's consent at this time, staff will proceed with the issuance of the Request For Proposal (RFP), return to the Board when short listing is required, and begin interviews. No further Board action would be required to issue the RFP.

Mr. Polen added, as an aside, that this is a process matter and should not reflect negatively, in any way, on our actuary consultants. He does not consider this an urgent action to slow down movement on other priority issues facing this Board. Through the normal RFP process a consultant could be selected and underway in three-six months. Mr. Matson agreed.

6. Presentation, Discussion, and Appropriate Action Regarding Recommendation from the Ad Hoc Board Governance/Organizational Development Evaluation Committee Regarding the Finalists to be Interviewed for Proposal No. RT03-006

Mr. Bruner commented that this project has been on the docket for a long time through no fault of anyone. He, Ms. Charlotte Borchert, and Mr. Polen attended the Ad Hoc Committee meeting held on February 13, 2003. At this meeting, they evaluated the recommendations of Mr. Bob Wittsell, Procurement Manager, and his staff, and determined they would now like to split this process into two parts, Board Governance and Organizational Development. The Board Governance portion, while always important, is even more important now in light of three new Board Members, and the loss of three Board Members' institutional knowledge. The Organizational portion of this project is more long term. He recommended interviews be conducted for the two different purposes. He added that this issue is so important that the Ad Hoc Committee felt the Board, as a whole, should be included in the selection, to allow them the opportunity to explore the project.

Mr. Tenney, regarding the Board Governance portion, asked to have clarified the disparity between the price quotes of the three finalists, from \$83,000 to \$285,000.

Mr. Bruner responded that the Committee did have a feeling that there was some overlapping with regard to responsibilities. During the negotiations, staff could bring the prices down to a more manageable price.

Mr. Wittsell cautioned that if this discussion becomes too involved in the contents of the proposal, a break into an Executive Session would be necessary. However, if the discussion is kept on a general level, not identifying any particular party, we can continue in public session.

Mr. Wittsell did contact a few of the Offerors. They are willing to decrease their fees in relation to the amount of work they are charged with, if the Scope of Work is changed. The RFP Scope of Work was very detailed and ambitious with regard to the how-to's and processes requested. The Offerors he spoke with asked if they were allowed more flexibility in determining how to meet the set objectives, the fees would decrease substantially by 50%.

Motion: Mr. Ray Rottas moved to approve the recommendations from the Ad Hoc Board Governance/Organizational Development Evaluation Committee regarding the three firms to be interviewed for the Board Governance portion of Request for Proposal RT03-006, and the four firms to be interviewed regarding the Organization Development portion of RT03-006.

Mr. Polen seconded the motion.

By a vote of 7 in favor, 0 opposed, and 0 abstentions, 2 excused, the motion was approved.

7. Presentation, Discussion, and Appropriate Action Regarding Agency Priorities

Mr. Matson, highlighted the one page summary of key priorities he has identified. Over the last three weeks he has had discussions with all the Board Members as well as senior staff members and project managers throughout the agency. The summary leads with the priorities that can be completed in a relatively short time span. As the listing continues, he recognizes that these priorities may take the remainder of this year and into next year to complete. All these projects are of a high level.

The first priority initiative concerns the ASRS Budget request which was submitted for approximately \$28,000,000. The Joint-Legislative Budget Committee has come up with a different figure. External Affairs and our budget team have gone to the Legislature, this morning, to communicate the agency's priority items we have underway and the reasoning behind the \$28,000,000 requested figure. The second Joint Sub-Committee is considering the budget now.

The second priority project includes the legislative initiatives sponsored by this agency or various other parties throughout the state.

The third listed priority is to add an additional attorney to the staff. At this time, Mr. Fred Stork, Assistant Attorney General, has many requests for his attention to various legal issues. In order to facilitate a more prompt response to many legal issues submitted, the need for an additional attorney is a priority. The Board has already moved to fund this position. Mr. Matson is working with the Attorney General's office to fill this position. He believes this can be accomplished by as early as the end of March.

The next two items are; Continuing Ongoing Communications and the Asset Allocation Study. Continuing Ongoing Communications is simply the plan to continue communication with external entities; employees, employers, legislators, etc. Mr. David Cannella, Communications and Media Relations Manager, is preparing a strategic plan for internal and external communications. In regard to the Asset Allocation Study; it is now time to review this plan and determine if new categories of assets should be included along with the assumptions associated with the current categories in the plan.

The Supplemental Retirement Savings Plan (SRSP) and the Deferred Retirement Option Plan (DROP), need terminological changes at the state legislature level. The SRSP was essentially inconsistent with Federal law and can not be implemented as it now stands. It is hoped that both of these plans have statutory amendments in place this year facilitating implementation to occur as early as the third or fourth quarter of this year.

Presentations concerning Board Rules and Mr. Rottas' Board Policies and Procedures Committee have been ongoing. By April of this year a series of as many as 35 Rules need to be brought before the Board for discussion.

The Retiree Health Insurance is an issue being addressed by many members of the Board. Many committee meetings and study groups are ongoing. Mr. Matson and others have met with the Arizona Health Care Cost Containment System (AHCCCS) to evaluate the different efficiencies that could be brought to the System. A broad perspective is being evaluated with concerns to retiree health insurance alternatives. A policy will be crafted with the information gathered from this evaluation and input from key individual's, Dr. Chuck Essigs, for example.

The Information Technology Plan is a project lead by Mr. Tom Funk. This plan includes; Public Employee Retirement Information System (PERIS), Telephone Upgrade, Website Imaging, Integrated Financial System, Workflow Analysis and so forth. This year has brought significant progress with these plans. Mr. Matson has met with key Information Technology (IT) staff, and Mr. Chris Cummiskey, Director, Government Information Technology Agency (GITA), to

discuss the most recent initiatives the ASRS is planning to submit to the Government Information Technology Agency (GITA) in order to receive authorization to move forward.

Mr. Matson is pleased with the ability of internal staff to modularize with regard to PERIS. We have received positive and negative feedback in response to these modules. This feedback allows our IT staff to improve the successive modules, to offer superior use. Additional comments can be found under Agenda Item #9, Director's Report.

Mr. Rottas complimented Mr. Matson on the excellent progress he is making during the short amount of time he has been Director.

Mr. Miller asked that the issue of Corporate Governance be added to the list of agency initiatives.

Mr. Matson concurred. Mr. Rottas added that the Board Policies and Procedures Committee is also working with the Director on this issue and making progress.

8. Presentation, Discussion, and Appropriate Action Regarding the Investment Management Division 2002 Accomplishments/2003 Goals

Ms. Charlotte Borchert arrived at 9:08 a.m.

Mr. Gary Dokes, Acting Chief Investment Officer, began with expressing his appreciation for the opportunity to work with the Board and the ASRS regarding investment related issues. He continued by outlining the accomplishments, goals, and objectives of the Investment Management Division (IMD).

Four Critical Functions of IMD:

1. Insure monies are available to insure the fund's cash flow needs.
2. Maintain the asset allocation targets as mandated by the Board.
3. Insure that all the portfolios have strict adherence to Board directives and Arizona State Statutes.
4. Maintaining ASRS's investment management values.

Additional contributions of IMD to the fund:

- Investment Manager Transition – Approximately \$2.5 billion in market value of equity securities transitioned over the last 14 months as a result of the Board's review and mandated action concerning three asset classes; small cap December-2001, mid-cap June-2002, large cap December-2003. Four managers were terminated, 11 managers were hired, six managers were designated as back-up managers.
- Effective management of the six in-house portfolios – four Equity and two Fixed-Income. During calendar year 2002, these funds achieved or exceeded index returns.
- Extensive in-house external manager oversight program is provided in four ways.
 1. Review portfolio activity on a continuous basis.
 2. Manager trades are checked so as to be in compliance with state statute and portfolio guidelines.

3. Look out for performance problems and flag issues.
 4. Keep up with contacts regarding “street” news about our managers.
- Continued promotion of the ASRS investment program through several outreach programs.

2003 Value Added Opportunities:

- Involvement in the current Asset Allocation Study.
- Establish IMD as a strong depository for information for the Investment Review Committee (IRC) and the Board.
- IMD will continue to be a check and balance for outside information received by the Board.
- Involvement in future manager transitions.
- Revisit the Investment Management Charter, our policies and procedures, and the Strategic Plan, previously reviewed by Mercer and approved by the Board in 2002, for the purpose of updating as a result of personnel changes. Completion set for second quarter of 2003. Mercer is to review the changes and then the documents go to the IRC and the Board.
- Continue to refine the Investment Manager Oversight Program. Consolidation of the fixed income and equity area.
- Continue to be involved in the oversight of our two real estate buildings. Mr. Eric Rovelli, Portfolio Analyst, is an experienced analyst in the area of real estate management.

Comments- Requests:

Mr. Norman Miller commented on his excitement regarding Mr. Dokes’ presentation and its utilization moving into the future. He also asked Mr. Dokes about the Global Tactical Asset Allocation interviews in the near future; could Mr. Dokes provide, before the interviews occur and for the Board Members participating, a fundamental sounding from his experience and staff resources to better prepare for the interviews? Mr. Miller would prefer this information be relayed soon. Perhaps by way of a short session to bring the Board Members up to date on this asset area. Mr. Dokes agreed to do this.

9. Director’s Report

Mr. Matson wished to recognize and welcome two new key staff members to the Agency. Ms. Nancy Linssen, Assistant Director of Financial Services, began employment at the ASRS on Monday, February 17, 2003. Ms. Kelly Orrick, Chief Legislative Liaison, External Affairs Division, also began employment at the ASRS on Monday, February 17, 2003.

Further, Mr. Matson highlighted Section D, Operations. The Arizona State Government Employee Satisfaction Survey is conducted once per year by the Governor’s Office for Excellence. The ASRS reached a significantly higher degree of satisfaction than the average state agency, 75-80% vs. 50%. He emphasized a number of key survey question results to illustrate the ASRS’s significantly higher degree of satisfaction. Also stressed was this agency’s strong commitment to employee development through training, whether academic or technical.

Section E, IT Plan, Mr. Matson noted the key summary of ongoing projects. He brought to the Board's attention two of the projects which are color coded brown, meaning there are some issues associated with these projects, but the issues should be recoverable. First, the PERIS Project's target date deadline is approximately one week behind schedule, but he does not feel this is of significance. Secondly, the Financial Accounting System Project can not move forward until authorization from the Information Technologies Authorization Committee (ITAC). A meeting with this Committee is scheduled for Wednesday, February 26, 2003.

Lastly, Section I, Correspondence Summary, was brought to the Board's attention because of the change in format from past Director's Reports Letters Sections. Correspondence received by the ASRS, both negative and positive, will be summarized in a spreadsheet format, this format is essentially set as a statistical summary without any personal information provided. This format will aid in recognizing vendor or unit negative trends.

Dr. Essigs was pleased with the Agency's maintained improvement rates shown in the survey summarized in Section D.

Mr. Rottas was glad to see that full disclosure is occurring regarding all activities of the ASRS. Both positive and negative aspects must continue to be disclosed in order to continue our success.

Motion: Ms. Gonzalez moved to accept the Director's report.

Mr. Rottas seconded the motion.

By a vote of 8 in favor, 0 opposed, and 0 abstentions, 1 excused, the motion was approved.

10. Presentation, Discussion, and Appropriate Action Regarding the Total Fund Performance for the Period Ending December 31, 2002

Mr. Terry Dennison, Principal, Mercer Investment Consulting, presented an economic and market review and reported on the Total Fund for the period ending December 31, 2002.

	Quarter	1 Year	3 Years	5 Years	Inception
Total Fund	5.7%	-12.1%	-6.7%	3.0%	10.6%
Benchmark*	6.2	-11.7	-7.7	1.7	8.5
RM Public Funds Median	4.9	-9.2	-4.8	-3.1	—

*1/1/89-12/31/91 is 60% S&P 500/40% LB Aggregate,
1/1/92-12/31/94 is 50% S&P 500/40% LB Aggregate/10% EAFE,
1/1/95-6/30/97 is 45% S&P 500/40% LB Aggregate/15% EAFE,
7/1/97-12/31/99 is 50% S&P 500/35% LB Aggregate/15% EAFE, and
1/1/00-Present is 53% S&P 500/30% LB Aggregate/17% EAFE.

11. Presentation, Discussion, and Appropriate Action Regarding the Performance of Domestic Small Cap Equity Managers for the Period Ending December 31, 2002

Mr. Seth Lynn, President, presented for Byram Capital Management.

			Annualized	Annualized
	4 Qtr 02	1 Year	3 Years	Since Inception
ASRS Return	9.9	(7.6)	12.3	13.9
Russell 2000 Index	6.2	(20.5)	(7.5)	4.3
Value Added	3.7	12.9	19.8	9.6

Inception date: August 31, 1998 Objectives were met

Mr. Kenneth A. Korngeibel, Sr. Vice President, Portfolio Manager, and Mr. Peter M. Hendricks, Sr. Vice President, Institutional Client Service, presented for Columbia Management Company.

	Quarter	1 Year	3 Years	5 Years	Since Inception*
Net Return	2.5%	-25.8%	N/A	N/A	-25.8%
Benchmark Return	7.5%	-30.3%	N/A	N/A	-30.3%
Total Value Added Relative to Benchmark	-5.0%	4.5%	N/A	N/A	4.5%

- Underperformed the Russell 2000 Growth Index by 500 basis points in the fourth quarter of 2002
- Outperformed the Russell 2000 Growth Index by 450 basis points for the year ended 12/31/2002

*January 2, 2002

Mr. Steve Clark, Portfolio Manager, and Mr. Damon S. Fisher, Regional Director, presented for Dimensional Fund Advisor.

	4 th			Since
Annualized	Quarter			9/1/98
Returns (%)	2002	1 Year	3 Years	Inception
ASRS Account	7.31	-14.07	4.77	9.36
Russell 2000 Value Index	4.92	-11.42	7.44	8.22
Total Value Added	2.39	-2.65	-2.67	1.14

While Dimensional outperformed in Q4, they did not meet the annual performance objective for 2002.

* Actual account inception date is August 31, 1998. Returns are net of fees

Mr. Richard Forster, Managing Director, Marketing, and Ms. Susan Ellison, CFA, Managing Director, Equity Portfolio Management, presented for Mellon Capital Management.

Mellon Capital's fund has exceeded the Russell 2000 Index return as shown below due to rebalancing strategies.

			Annualized	Annualized
			Annualized	Since
Benchmark Return	4Q02	1 Year	3 Year	Inception
ASRS (net of fees)	5.90%	-19.67%	-6.74%	5.22%
Russell 2000	6.15%	-20.48%	-7.55%	4.33%
Value Added	-0.25%	0.81%	0.81%	0.89%

*Inception: August 31, 1998

Mr. Bruner excused himself from the meeting at 11:15 a.m.
Mr. Rottas became acting chairman at this time.
A quorum remains present for the purpose of conducting business.

4. Agenda item 4 was addressed at the end of the meeting to include Mr. Stephenson's presence. Presentation, Discussion and Appropriate Action Regarding the Legislative Update

Mr. Rottas brought the Board up to date on the Legislative Committee's discussions regarding the Service Purchase and Anti-terrorist Bills. He asked Mr. Dennison to address the Board as to his thoughts and information regarding these bills, because the Committee did not have any information resources to aid their discussions.

Mr. Dennison offered that post September 11, 2001, concerns have been expressed by large pools of capital, such as public pension funds, to make sure that no investments in any way facilitate, directly or indirectly, terrorism organizations and the countries that support them. The ASRS is invested in hundreds of companies operating worldwide. He also works with the Colorado Public Employees Retirement Association (PERA). He first became exposed to this concern when the State Treasurer of Colorado, Mr. Mike Koffman, raised an issue with the PERA Board, on the subject of whether managers should be asked to look at the companies represented in the portfolios, because essentially investment represents ownership in these companies. This part ownership raises a concern with the companies who support, directly or indirectly, terrorism. The Colorado association was the lone voice of concern until now.

Clearly, no one wants to aid, directly or indirectly, terrorism activities. The problem is, in the real world, many companies are global. The more criteria that is placed on the investment process, results in a more diminished opportunity to invest. Questions arise as to how an evaluation is conducted of investment companies. How do you implement? How do you come up with a list of companies? What about joint ventures? It is important to not have the investment process focused on non-investment decisions. Ultimately, the ability of the ASRS to provide the benefits that have been promised relies on investment performance. The majority of every benefit dollar is investment return. The more difficult the process to achieve those returns, the more difficult it becomes to support the benefit structure, which is the main objective of the ASRS. While there is no wish to interfere with the political process of the State of Arizona, the imposition of non-investment considerations into an investment process can be thought of as hurtful to a degree, and in the long run, hurtful to the primary objective for which this retirement system exists. This objective assures the security of the benefits that have been promised for public employees in the State of Arizona.

Mr. Rottas added that there is no precedence regarding reaction to this type of bill, which leaves the State of Arizona the first state to move forward with this legislation.

Mr. Dennison is not aware of any large fund that is taking action. The implementation would be very difficult. To his knowledge, eight or nine states have proposed legislation and/or discussed this issue. However, there has not been action beyond the thinking stage.

Mr. Rottas then asked the Board if they should ask the Legislature not to take action on this legislation until further information is available and ensuing results of the legislation is clearer.

Mr. Polen asked to the status of this proposal.

Mr. Rottas responded that it was introduced by Mr. David Petersen, State Treasurer, and it is now being considered by the Legislature.

Ms. Orrick, spoke in Mr. Stephenson's absence. She added that there are three measures that the Legislature is considering. A Senate version of the Terrorist Bill, an identical House version, and a House Concurrent Resolution. The Senate Bill, sponsored by Senator Dean Martin, has passed the Senate Finance Committee in a 7 to 1 vote, and now goes straight to Rules. The House version, which is sponsored by Senator Steve Yarbrough, has not had its first hearing, but is on the schedule for February 25, 2003. The House Concurrent Resolution has passed through Government and Retirement.

Mr. Polen asked if the versions require the same action.

Ms. Orrick stated that the only difference is with the House Concurrent Resolution which is advisory in nature, recommending the various funds establish protocols and procedures to meet the guidelines of the bill. The House and Senate versions are directory. There are actions that would be required to be taken by anyone managing public monies in the State of Arizona.

Mr. Tenney stated his understanding of the Committee Chairman's concerns regarding the legislation is that it is too broad, and premature, and it would be good for the Board to submit a statement.

Ms. Borchert asked if the reporting requirements associated with this bill are as ominous as they appear? She also asked for the Committee Chairman to speak to the fact that there probably is only one company in the country that can create these reports.

Ms. Orrick added, that from her perspective and others who have looked at the legislation, the reporting requirements appear to be extraordinarily difficult to meet, there are some ancillary requirements dealing with communication between individual fund managers and companies regarding the strategies in place to prevent tax dollars to be paid in countries that use this money to support terrorism activities. The only company Ms. Orrick knew of that deals with this type of evaluation is Global Risk Securities, based in California. This company has developed a product which tracks the data of companies that have investments in the federally designated terrorism sponsoring countries. A subscription cost for each fund manager would be \$12,500. Even Global Risk Securities cannot provide all the information required by the measures of this legislation.

Ms. Borchert was uncomfortable that a Board motion or vote would be interpreted as the Board being in favor of terrorism. However, if we have information available to conduct an evaluation of the costs of having the reporting completed by this agency, the cost would be prohibitive without an appropriation attached.

Mr. Rottas stated that the problem is that there is no information available. He believes the Legislature should be advised as to the Board's concern for getting involved with this type of legislation without a complete evaluation of the possible impact on the management of the ASRS.

Mr. Polen added his observation that the cost information is relative, but the big picture is when you have a \$17 billion dollar portfolio, the basis points asked for this required analysis would be great. The important measure to get to the Legislature is that social and political constraints are a bad idea and inconsistent with fiduciary responsibilities. He has serious doubts as to the ability of the Board to operate in its fiduciary responsibilities under these kinds of constraints.

Mr. Dennison expanded on Mr. Polen's observations regarding the impact on the management of the assets. If we focus on the equity, not looking at the bond piece, this includes about 11 to 12 billion dollars worth of equity. Much of this amount is invested passively with index funds. As has been presented today, a huge number of stocks are held in the indexes. If the potential of aid and facilitation to terrorist activities has to be looked at concerning every one of these securities, literally, you will have managers asking for you to come get your money. They will impose an enormous burden and cost. The possibility of being able to index may be forsaken, this being a low cost effective strategy for managing large sums of money. There are stocks on the index that have overseas actions. In reality, it will become impossible to run the fund. Mr. Dennison offered his firm's assistance because of the importance of this issue. A conflict will arise with the passage of this bill as to the charge of this Board overseeing these monies.

Mr. Dennison stressed the concern is not the cost of execution but the concern is on the impact on the cost of the investments. Impact of a basis point multiplied by 17 billion dollars is a lot of money.

Mr. Tenney added that if nothing is done today the opportunity passes. He agreed with Mr. Polen that some type of statement is appropriate.

Mr. Polen believed it appropriate for the Board as a group to send a message to the Legislature, that it believes that this type of proposal is injurious to the members of the Arizona State Retirement System, and to strongly urge them to not pass these measures.

Mr. Tenney wished to add the clause; while the Board does not support terrorism, we never the less believe these measures are injurious.

Mr. Rottas wished to add that the Board is unable to ascertain the costs of such an action. We feel that these measures would jeopardize our ability to provide the services we are required to provide.

Mr. Polen suggested Mr. Matson draft a letter addressing these issues that can be signed by the Board Members to be delivered to the Legislature as a testimony. Mr. Polen would be willing, if given adequate notice of when the hearings are scheduled, to give testimony in the capacity of Chairman of the IRC.

Mr. Rottas asked Mr. Stork if this type of "lobbying" is appropriate.

Mr. Stork stated that this type of Board action is not prohibitive lobbying. Given, ultimately that the state of Arizona is the trustee of these funds, and the Board Members are the appointed representatives of the trustee, and are responsible for carrying out the trustee's duties, the Board has the unique position and access to the information and knowledge that the Legislature, along with the Governor, the ultimate policy making body, need to know when considering measures such as this, which have a more significant impact on the fund and its beneficiaries than probably anything else that I have heard since I have been sitting as legal counsel to the Board. The Board is obligated to bring to the attention of the Legislature the impact, issues, and problems that must be addressed and resolved in order to arrive on an informed judgment whether this type of policy is an appropriate way to proceed in the management of the fund. The Legislature needs to know that the management of the fund will be impossible with these measures in place. Because the investment management field will not be willing to accommodate any longer, thus leaving the Board to manage the fund. A letter from the Board to the Legislature is a very appropriate vehicle for notification and the offer of assistance from the Board Members, Director, CIO, Investment Managers, and others also holding the knowledge and credibility to provide input into the final decision made on this issue.

Mr. Dennison added that this measure also is binding on the "internal" management process.

Dr. Essigs wished to add to the letter the clear statement that the Board is in opposition to the involvement of companies in terrorism, and encourages the Federal government to aggressively prosecute any companies that do that. Making it clear we are not supporting terrorism, but this is not the way to get to these companies.

Mr. Rottas asked Mr. Stork for his recommendation on how to proceed.

Mr. Stork recommended a letter be drafted for the Board's consideration. A vote on this issue today is allowed. Or the Board may reserve their vote until the actual document is in hand.

Motion: Mr. Polen moved that the Board direct the Director to prepare a letter expressing the Board's very serious concerns about this Legislation. To do so as rapidly as possible, preferably by Monday morning for review by the Board Members and delivery to the Legislature.

Mr. Tenney seconded the motion.

By a vote of 7 in favor, 0 opposed, and 0 abstentions, 2 excused, the motion was approved.

Mr. Miller suggested our lobbying staff go to the Legislature to ask the leadership to withdraw this legislation from immediate consideration by respective committees of the whole. This "Feel Good" kind of legislation has a way of accelerating quickly, and he felt the Board needed to advise leadership that a very important document is coming over to them, and to postpone any action on the floors of the houses until this information is received.

Mr. Miller added, "Paul's letter should try to detail, not only the impracticality but the cost involved, and if the Legislature saw fit for us to go forward, notwithstanding our objection, they give consideration to revising our fiduciary responsibilities and duties in the statute as well."

Mr. Trachtenberg asked for copies of the legislation to be submitted to those involved.

Mr. Maguire returned at 11:49 a.m.

Ms. Orrick continued her presentation commenting on the rapid pace the Legislature is now moving in once the bills have been proposed. The ASRS initiatives are moving very well. The Service Purchase bill, the Modified DROP bill, and the Technical Name Change bill are all very far along in the process and doing very well.

The Legal Counsel bill, exempting the ASRS from the Attorney General's provision, was passed in the Senate Finance Committee, but failed in the Judiciary Committee on a party line because there were two members of the majority party not in the room at the time and it went down by a three to four vote. However, the morning of February 21, 2003 this bill was posted for reconsideration on the Senate Judiciary agenda for February 26, 2003.

The Contributions Not Withheld bill has passed the House and is now in Senate committee. This legislation contains a provision to change the "hold harmless" for employers from a 15 year level to a six year level. However, the Board does not wish to completely oppose this bill because there are additional substantive provisions in the bill. This bill has been discussed by the External Affairs Committee.

Mr. Maguire asked Ms. Orrick for help in understanding if the question of the 6 years vs. 15 years was not included in the bill, would there be other provisions in the bill worth moving forward for?

Ms. Orrick said "Yes," and recommended three options; One: Proceed forward as it is currently written. Two: Agree to amendments to drop from the 15 year provision to something else. Three: Take out the 15 year provision altogether, and proceed with the remaining provisions of the bill. There are substantive issues worth continuing to pursue.

Ms. Borchert would like to hear from staff in regard to how to proceed. She does not want to hold up the bill if there are additional substantive issues remaining in the bill.

Mr. Stork added that the ASRS does receive requests for calculations based on circumstances of 20-30 years previous. This is a problem in the assessment and analysis of these situations. The ASRS statutes do not address any time limit. The past practice in responding to a situation when an individual is seeking credit for past service has been to notify the employer that contributions are due, and this results in questions over the lack of earnings records. For the most part, employers have paid these requests, with some grumbling. He noted that there is litigation ongoing in regard to the time limit issue. The employer has interposed as a defense that this is a contractual dispute between the employer and the employee. This time limit issue should be addressed in ASRS statutes to clarify the time limits to put an end to these disputes. Thus, if the employers are not following the ASRS statutes appropriately there is a better way to respond other than relying on a bill of Contributions Not Withheld that is 30 years old. Mr. Stork does not have an opinion on the appropriate length of time.

Ms. Gonzalez excused herself at 11:57 a.m.

Motion: Mr. Maguire summarized the motion as; The Board will stand with the existing legislation at 15 years, with the other changes adopted by the External Affairs Committee's last meeting, and move forward on that basis.

Ms. Borchers seconded the motion.

By a vote of 7 in favor, 0 opposed, and 0 abstentions, 2 excused, the motion was approved.

Regarding the Rural Health Insurance Supplement; the Senate version is held up in Committee. The House version has passed through Government and Retirement Committee with an amendment; in 2004 the existing rural health insurance supplement would be extended but would also, be reduced by 10% and in 2005 it would be reduced by an additional 15%.

This bill now goes to Appropriations

NOTE: PacifiCare's extension of coverage bid is contingent on the full funding of the continued supplement. PacifiCare is reviewing the amendment and will return to the ASRS with more information.

Mr. Maguire added that PacifiCare will come back to the ASRS and inform us whether or not their offer is to hold their current contract rates for one more year. An answer is expected on Tuesday, February 25, 2003.

Mr. Maguire asked for the Board's recommendation to support the position with regard to Rural Health Insurance that would allow the ASRS to keep PacifiCare and to keep the current rate extension in place. There is no value to improve the supplement or keep the current supplement if the cost of premiums will increase because the contract has to go out to bid again.

Dr. Essigs agreed that people would rather see a smaller subsidy and no increase in premium.

Mr. Miller excused himself at 12:10 p.m.

Motion: Ms. Borchers moved to keep the PacifiCare extension in place for one more year in order to give the Health Insurance Committee time to work to a permanent solution.

Mr. Tenney seconded the motion.

By a vote of 6 in favor, 0 opposed, and 0 abstentions, 3 excused, the motion was approved.

12. Board Requests for Agenda Items

None.

13. Call to the Public

Ms. Mary Cronin, County Attorney for Maricopa County, informed the Board of the one lawsuit now being litigated concerning the service purchase issue. The County's desire is to change the limitation to a six year level to be consistent with the current law for statute of limitations for breach of contract claims. She felt this is a generous statute of limitations. Maricopa County would be opposed to a 15 year statute.

14. The next ASRS Board meeting is scheduled for Friday, March 21, 2003, at 9:30 a.m. in the Conference Room of the ASRS Tucson Office at 7660 East Broadway Boulevard, Tucson, AZ 85710-3776

15. Adjournment of the ASRS Board.

Mr. Alan Maguire, Chairman, adjourned the February 21, 2003, meeting of the ASRS Board at 12:19 p.m.

ARIZONA STATE RETIREMENT SYSTEM

Susan C. Gomez, Secretary

Date

Paul Matson, Director

Date